

ICPS newsletter®

Ukraine's energy policy must be revised in the light of Russia's "blackmail"

As a result of Russia's attempt to pressure Ukraine politically using gas deliveries, Ukraine's Government must hold immediate consultations with stakeholders to revise the nation's energy policy. The country can avoid this kind of "blackmail" with gas prices in the future by setting up an alternative gas transport consortium with the EU that excludes Russia and by implementing a policy to reduce energy consumption across the economy through a transparent domestic energy market, incentive-based methods to regulate the energy and residential services sectors, the promotion of energy conservation among consumers, tax benefits to energy-conservation projects, incentives to invest in sectors that are low in energy consumption, and conditions that make it possible to implement the Kyoto Protocol

The Ukrainian–Russian gas crisis was a wake-up call regarding real and potential threats to Ukraine's energy security:

- inefficient use of fuel and energy resources;
- the lack of active energy-saving policies;
- a slow pace of diversification of energy sources;
- poor ecological state of energy-intensive industries;
- social tension around energy-intensive manufacturing and fuel supplies to the general population.

Two unavoidable consequences of the gas conflict must be to eliminate threats to national security and to reduce the country's political dependence on Russia.

A gas transport consortium—without Russia

Regardless of any economic arguments underlying the actions of the Putin Administration, it is hard to ignore the obvious desire of Russia's leadership to pressure the Yushchenko Administration with the aim of keeping Ukraine within Russia's geopolitical sphere of influence and forcing the country to abandon the idea of European integration—not to mention a more mercenary desire to get control of Ukraine's gas transport system.

Increased gas prices are likely to have a negative impact on Ukraine's economy only in the short term. Within five years, the economy would recover and the

country's dependence would be reduced. This scenario is not useful to Russia, which is willing to use the gas issue just to intimidate and pressure Ukraine. The agreement between NAK NaftoGaz Ukrainy and OAO Gazprom regulating relations in the gas sphere does not tackle the issue of Russian claims on Ukraine, but only postpones the next stage of the gas war for another six months or—more likely—until the beginning of the next heating season.

Ukraine's answer to this threat could be to set up an alternative gas transport consortium involving European gas companies, that is, a consortium of gas consumers that does not include Russia. This approach to managing Ukraine's gas transport system would allow European consumers to receive cheaper gas, at the price that is effective at the Ukrainian–Russian border, whereas Ukraine would receive greater guarantees of energy independence from its EU partners.

*For more on the options for attracting investment to Ukraine's gas transport system, in particular about the costs and benefits of setting up various forms of gas transport consortia, see **icps newsletter** №171 of 23 December 2002. To view this issue, visit us online at: <http://www.icps.com.ua/eng/publications/nl.html?2002>.*

A new energy policy

The problem of Ukraine's security lies not so much in Russia's unfriendliness towards Ukraine's current government as in the

The latest issue of political commentary

The dismissal of the Yekhanurov Government was the low point in the stand-off between the Verkhovna Rada and the Government. The sacking was made possible because the Bloc of Yulia Tymoshenko and the Lytvyn bloc joined forces with the Party of the Regions. The rating of the latter continued to climb in December, when it remained the frontrunner in the bid to lead a Verkhovna Rada majority after the elections. What impact the signing of a gas agreement and the dismissal of the Cabinet have had on public opinion remains to be seen. Aggressive political competition has so far not led to better quality in government policy.

The gas war that turned into a virtual deadlock between Ukraine and Russia on a slew of economic and political fronts ended with the signing of a bilateral agreement. The EU and the US were on the side of Ukraine in the conflict over gas deliveries. Membership in NATO has become even more likely for Ukraine.

A sharply worsening domestic political battle complicated the passing of the 2006 Budget and left its mark on the quality of the document. Growing energy prices are spurring the introduction of a nationwide policy of energy conservation in Ukraine. The new gas agreement with Russia did not settle long-term prospects for gas deliveries. Worse, it prevented Ukraine from saying good-bye to the shadowy schemes that have long been the practice in gas trading.

Over 2005, Ukraine's economy grew the slowest it has since the boom that began in 2000. Despite continuing high growth in consumption, investment in Ukraine's economy shrank. Real disposable household incomes grew 20.5%.

*For more on the summary of the last month's events, read **political commentary**, which analyzes government policy and the sources influencing policy-making in Ukraine. To subscribe, contact Andriy Starynskiy by phone at (380-44) 484-4410 or by e-mail at marketing@icps.kiev.ua.*

great vulnerability of its economy to energy prices. The years of mild Budget pressure on companies and on the residential services sector only put off the inevitable need for a radical overhaul of the energy component of Ukraine's economy. According to ICPS economists, there are several key directions for energy-saving policy:

Increasing transparency in the domestic energy market and the trade in fuels.

The opacity of the schemes for settling for Russian and Turkmen gas and of gas distribution to various sectors of the domestic economy are a clear invitation to corruption. To ensure transparency in the oil and gas sector, NAK Naftogaz Ukrainy needs to be reorganized and the gas and power markets need to be much more actively liberalized. The entire system of settlements for gas, especially the role of such intermediaries as RosUkrEnergo, needs to be overhauled.

Using incentive-based methods of regulating the energy and residential services sectors.

The current command approach to regulating rates among natural monopolies (cost-plus) actually encourages those companies to inflate production costs. A pilot project implemented over 2002–2004 by the regulator, which provided incentives to reduce losses on power grids, led to a 20% reduction in such power leakage—evidence that positive change is possible in this sphere.

Providing incentives for energy conservation among the general population. The Government should stop cross-subsidizing residential users at the expense of industrial customers because it is an inefficient form of social assistance. Rates for residential consumers are overly low in Ukraine, compared to other Central and Eastern European countries. Increased rates and improved tracking of consumption will encourage more economical use.

Minimizing taxation of energy-saving projects. The approved 2006 State Budget offers no options for this kind of move. However, since it looks likely that the Budget will be revisited during the upcoming year, this option should be considered at that point.

Promoting structural transformations in the economy. According to ICPS economists, the potential for further rapid growth in the metals and chemicals industries has been exhausted. There is no

compelling reason for the Government to provide state support to energy-intensive sectors or to interfere in capital flows to sectors with high added value and low energy consumption. Once sectors such as machine-building and food-processing begin to integrate into global production chains, Ukraine's economy will be less vulnerable to energy shocks. The Government should support such promising sectors as transport, energy-conservation, high-tech products and services, and new agriculture.

Instituting mechanisms to attract "green" investment. If Ukraine starts to implement the instruments provided by the Kyoto Protocol, it could attract significant foreign investment to the country's most energy-intensive sectors. According to World Bank estimates, Ukraine could potentially offer between 1.5bn and 1.8bn t of CO₂-equivalents in greenhouse gas credits at US \$5–12/t. Revenues for owners of joint conservation projects could be in the range of US \$3–7/t of CO₂-equivalent reduced or captured from the atmosphere. To strengthen environmental regulation and encourage energy efficiency, the Government must, first of all, complete the process of setting up national systems for tracking greenhouse gas emissions and reducing them on Ukrainian territory.

Energy conservation's hour has come

Over the next few years, Ukraine can expect to face a radical reconstruction of its industry, energy sector, residential services sector, and the public and residential sectors, first of all, in terms of energy consumption. Given the pressure coming from Russia, Ukraine's economy has to be restructured within 2–5 years since energy-saving policy was not implemented for the entire 14 years of independence. The time has come for producers and suppliers of energy-saving technologies to shine.

The potential of Ukraine's energy-saving market for the next 30 years is estimated in billions of US dollars. According to the Institute of General Energy under the National Academy of Sciences of Ukraine, Ukraine's energy-saving potential is around 42–48%. The biggest energy economies can be achieved in industry, 38%, in the residential services sector, 30%, and directly in the fuel and energy sector, 17%. According to calculations by the National Security Council and the

National Institute for Strategic Studies, Ukraine could save about US \$38bn until 2020 by cutting energy consumption. This will amount to net savings of US \$15bn for the State Budget, after the costs of conversion and refitting are taken into account.

To achieve such results, energy-saving and more conservative consumption of natural resources must become a government policy priority for the years to come. Ways to tackle the problem of energy dependence must be identified through an open public policy campaign and consultations with stakeholders and, then, introduced to the National Security Strategy by the president.

For additional information, contact ICPS's security and defense policy specialist Viktor Chumak by phone at (380-44) 484-4400 or by e-mail at vchumak@icps.kiev.ua.

ICPS announces competition for economic analyst

Requirements:

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